



DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

FEB 20 2001

CC:TEGE:EO2:SLCaden
FREV-127376-00

MEMORANDUM FOR TOM MILLER
ACTING DIRECTOR, EO R&A T:EO:RA
Attn: Bob Fontenrose

FROM: Chief, Exempt Organizations Branch 2
CC:TEGE:EO2

SUBJECT: [REDACTED]

This memorandum responds to your request dated November 9, 2000 that we review [REDACTED] §501(c)(3) application. As its principal activity, the applicant has entered into a joint venture with a for-profit entity. You suggest that [REDACTED]

[REDACTED]

Background

[REDACTED] is a [REDACTED] nonprofit corporation formed in [REDACTED] was organized exclusively to benefit and carry out the charitable purposes of its sole member, [REDACTED] (Hospital), which is an organization described in §501(c)(3). The Hospital is a [REDACTED] public community hospital owned by [REDACTED] and [REDACTED]. [REDACTED] is applying for exemption as an organization described in §501(c)(3). [REDACTED] is a for-profit limited liability company, whose members are [REDACTED] local physician-surgeons licensed to practice medicine in [REDACTED].

The Hospital formed [REDACTED] to enter into a joint venture with [REDACTED] to improve the ambulatory surgical health care services to the citizens of [REDACTED] and the surrounding community. The joint venture is called [REDACTED] (the Joint Venture). [REDACTED] each contributed \$[REDACTED] in capital to the Joint Venture in exchange for [REDACTED] % ownership interests in the capital and profits of the Joint Venture. To finance the construction of the ambulatory surgery

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center, the Joint Venture borrowed \$[REDACTED] from an unrelated third party financial institution. [REDACTED] also borrowed the same amount from the Hospital to loan to the Joint Venture. The financing is held in escrow, and is disbursed equally as construction proceeds and funds are needed. [REDACTED] represents that both loans are commercially reasonable and contain equivalent terms. Each loan requires repayment over a [REDACTED] year term, but it is unclear whether the loans will be fully amortized in [REDACTED] years. Each loan bears the same interest rate. [REDACTED] and its individual physician investors have guaranteed both loans. The file does not contain copies of their guarantees. The third party financing is a first priority lien against the real property improvements and other assets of the Joint Venture, and [REDACTED] financing is a second priority lien against such assets. Profits, losses and cash distributions are allocated equally, and are in proportion to the ownership interests held by each member.

New members are admitted to the Joint Venture by a majority vote of the members based on their governance interest. Governance interest is defined as the member's right to vote on matters presented to the members as provided for in the agreement. [REDACTED] each have [REDACTED] votes. Member meetings may be called for any purpose by any member holding at least [REDACTED]% of the governance interest, and are presided over by the chairman of the Joint Venture's Board of Managers. A majority of all governance interests shall constitute a quorum, and a majority vote of all governance interests is required for member action. In the event of a deadlock, any member holding at least [REDACTED]% of the governance interest can submit an issue to binding arbitration if it deems the issue important (one to which affirmative action must be taken for the surgery center to carry out its purpose). The arbitration shall resolve the issue in a manner consistent with the purposes provision (section [REDACTED]) of the operating agreement.

There is no third party management company engaged to manage the business and affairs of the Joint Venture. The operating agreement provides that the Joint Venture shall be managed by the Joint Venture's Board of Managers, consisting of three managers appointed by [REDACTED], and three managers appointed by [REDACTED]. A quorum of the Board of Managers consists of at least three managers and shall include at least one [REDACTED] manager and one [REDACTED] manager. If a quorum is present, a majority vote of the managers present is required for action. In the event of a deadlock, the issue will be submitted to a vote of the members (who may submit the issue to arbitration).

Management committees are authorized, and must consist of at least one [REDACTED] manager and one [REDACTED] manager. The management committees are authorized to manage the business and affairs of the Joint Venture, except a committee may not:

- a. Authorize distributions, except according to a formula or method prescribed by the Board;

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- b. Approve or propose to members action required by law to be approved by the members;
- c. Fill the vacancies on the Board or any of its committees;
- d. Approve a plan of merger not requiring Member approval;
- e. Authorize or approve reacquisition of membership interests, except according to a formula or method prescribed by the Board; or
- f. Authorize or approve the issuance or sale or contract for sale of membership interests, or determine the designation and relative rights, preferences and limitations of a class or series of membership interest.

The operating agreement does not provide that [REDACTED] has control over the Joint Venture's annual capital and operating budgets, distributions of earnings, selection of key executives, acquisition or disposition of facilities, material contracts, or changes to the types of services offered.

Section [REDACTED] of the operating agreement provides that [REDACTED] has the unilateral right to take actions on behalf of the Joint Venture that are required to protect its tax-exempt status or the Hospital's tax-exempt status under §501(c)(3). Under this section, [REDACTED] purports to have the sole authority to require the treatment of Medicare/Medicaid patients at the Surgery Center, to require the treatment of indigent patients without regard for the ability of such patients to pay for services rendered at the Surgery Center, and formulate, implement and control the charitable care policy of the Joint Venture and the Surgery Center. In addition, section [REDACTED] provides that [REDACTED] has the authority to bind the Joint Venture and the Surgery Center to a managed care contract in which the Hospital is a participant so long as the percentage discount required by the contract is reasonable. [REDACTED] represents that the governing documents are legal, binding, and enforceable.

Section [REDACTED] of the operating agreement provides that if the Joint Venture needs funds to finance operating deficits, the Board of Managers shall make a call for additional capital contributions from the members in the amount of required funds. Each member must advance the required funds pro rata in accordance with their respective membership interest. Membership interests are defined as the aggregate of each member's financial interest, governance interest, and the right to transfer or assign either or both of the financial or governance interest. If any member fails to advance the additional capital, the other member shall have the right to advance the required capital as an additional capital contribution to the Joint Venture, and the membership interests of the members shall be adjusted accordingly.

[REDACTED] represents that it has posted signs and published advertisements describing the Joint Venture's charity care policy. While there is no copy of this in the administrative file, [REDACTED] indicates that the Joint Venture's charity care policy will resemble the Hospital's charity care policy, which is based on federal poverty guidelines and is available to patients who qualify and fill out the proper application.

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The operating agreement does not specifically state that the Joint Venture has a duty to promote the health of a broad cross section of the community. It states that the Joint Venture will operate the surgery center and will govern its affairs for the mutual benefit of [REDACTED] and [REDACTED], the Hospital, and the citizens of the Hospital's service area. The operating agreement also states that the Joint Venture will provide services at the surgery center to any patient without regard to ability to pay. There is no provision in the operating agreement that in the event of a conflict between the community benefit standard and the maximization of profits, the Joint Venture will satisfy the community benefit standard without regard to profitability.

The operating agreement and certificate of formation may only be amended by majority vote of all members. There are no individual or separate financial arrangements or other arrangements between the Joint Venture or [REDACTED] and any officer, director, member or former member of [REDACTED] or the Hospital.

Law and Analysis

Section 501(c)(3) provides, in part, that organizations shall be exempt from federal income tax if they are organized and operated exclusively for charitable purposes, provided no part of the organization's net earnings inures to the benefit of any shareholder or individual. Treas. Reg. §1.501(c)(3)-1(d)(2) provides that the term "charitable" is used in §501(c)(3) in its generally accepted legal sense.

Promotion of health has long been recognized as a charitable purpose. An organization that seeks exemption on the basis that it promotes health must distinguish itself from ordinary commercial entities that provide health care services. See Federation Pharmacy Services, Inc. v. Commissioner, 72 T.C. 687 (1979), aff'd, 625 F.2d 804 (8th Cir. 1980); Sonora Community Hospital v. Commissioner, 46 T.C. 519 (1966), aff'd, 397 F.2d 814 (9th Cir. 1968). Whether an organization promotes health in a charitable manner is determined under the community benefit standard. Rev. Rul. 69-545, 1969 C.B. 117; Sound Health Ass'n v. Commissioner, 71 T.C. 158 (1978), acq. 1981-2 C.B. 2; Geisinger Health Plan v. Commissioner, 985 F.2d 1210 (3rd Cir. 1993).

In Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. 1324 (1980), aff'd 675 F.2d 244 (9th Cir. 1982), the Tax Court held that a charitable organization's participation as a general partner in a limited partnership did not jeopardize its exempt status. The organization co-produced a play as one of its charitable activities. Prior to the opening of the play, the organization encountered financial difficulties in raising its share of costs. In order to meet its funding obligations, the organization formed a limited partnership in which it served as general partner, and two individuals and a for-profit corporation were the limited partners. One of the significant factors supporting the Tax Court's holding was its finding that the limited partners had no control over the organization's operations.

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Revenue Ruling 98-15, 1998-1 C.B. 718, provides additional guidance on joint ventures between tax-exempt and taxable health care organizations. The revenue ruling describes two whole-hospital joint venture transactions. In Situation (1), the joint venture is governed by a majority of members appointed by the exempt organization who have no economic interest in the venture. A management company is contracted to provide day-to-day management services for a five-year period, but major decisions relating to management of the joint venture operations are retained for the governing board. The governing board members are under a duty to operate the joint venture in a manner that furthers charitable purposes by promoting health for a broad cross section of the community, and that duty overrides any duty they may have to operate the joint venture for the financial benefit of its owners. In Situation (2), the joint venture is governed equally by members appointed by the exempt organization and by the for-profit entity. The management company hired to provide day-to-day management services is a wholly-owned subsidiary of the for-profit entity, and is renewable at the subsidiary's discretion. The joint venture is not bound by the governing documents to serve charitable purposes or otherwise provide its services to the community as a whole. The revenue ruling concludes that in Situation (1), the joint venture qualifies for exemption under §501(c)(3), and in Situation (2), it does not because the benefit has more than incidental private benefits flowing to the for-profit entity.

In Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999), appeal pending (9th Cir.), an adverse determination was upheld with respect to a subsidiary of a §501(c)(3) health care organization whose sole purpose was to enter into a partnership with a for-profit company to provide outpatient surgical services. The Tax Court held that the subsidiary had ceded effective control over the operations of the surgery center to private parties, conferring impermissible private benefit. The Tax Court based its findings on (1) the lack of obligation that charitable purposes be put ahead of economic objectives, (2) the lack of voting control on management issues, and inability to guarantee charitable objectives will be placed ahead of economic objectives, and (3) the lack of informal control or influence over the partnership's activities.

1. Financing

To finance the construction of the surgery center, the Joint Venture borrowed \$[REDACTED] from a third party lender, and [REDACTED] borrowed \$[REDACTED] from the Hospital to loan to the Joint Venture. [REDACTED] and its physician investors guaranteed the third party financing and well as [REDACTED] loan from the Hospital. [REDACTED] claims that these guarantees have economic substance in that [REDACTED] and the physician investors "have the ability to perform" under the guarantees. Other than providing this statement, the file does not indicate the terms or duration of these guarantees.

Recommendation:

[REDACTED]

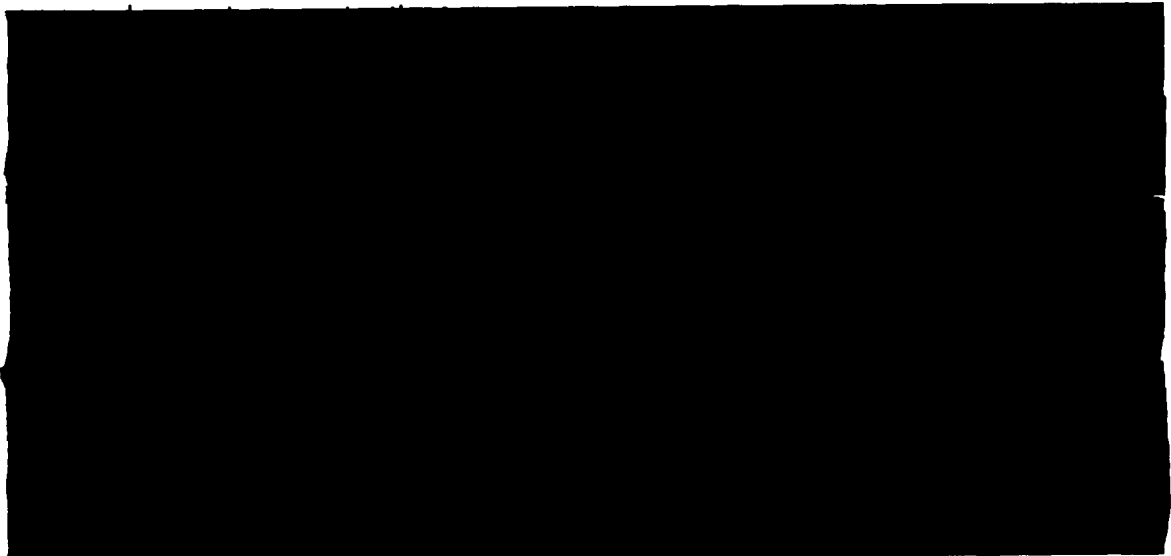
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2. Operational Test

A. Charitable Purposes

For [REDACTED] to satisfy the operational test in Plumstead, the Joint Venture's organizing documents must limit its purpose to one or more exempt purposes and not expressly empower the organization to engage, except insubstantially, in activities that do not further its exempt purpose. Treas. Reg. §1.501(c)(3)-1(c)(1). The existence, therefore, of a substantial nonexempt purpose is fatal to §501(c)(3) qualification.

We believe that [REDACTED] fails to qualify for recognition of exemption under §501(c)(3) because the Joint Venture is organized to serve substantial non-exempt purposes. Section [REDACTED] of the operating agreement provides that the purposes of the Joint Venture are to:



The Joint Venture's operating agreement expressly permits the Joint Venture to engage in activities that do not further an exempt purpose. Section [REDACTED] provides, in part, that the business of the Joint Venture is to own and operate an outpatient surgery center and engage in any other kind of lawful activity related to the surgery center. Other objectives are to provide patients in the community with a convenient, high quality, competitively priced alternative for outpatient surgery, and to provide doctors with access to an outpatient surgery center to use in connection with their private practice and to utilize current technology innovations. These are not charitable purposes. See Federation Pharmacy Services, Inc. v. Commissioner, supra; Geisinger Health Plan v. Commissioner, supra.

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In addition, the last sentence in section [REDACTED] provides that the Joint Venture will operate the surgery center for the *mutual* benefit of [REDACTED] the Hospital, and the community. This is problematic because [REDACTED] and [REDACTED] have different objectives: [REDACTED] is operating a for-profit medical practice, and [REDACTED] is applying for recognition as a charitable health care organization. Charitable purposes and profit maximization are conflicting objectives, and it is impossible for [REDACTED] to limit its activities to exempt purposes when it is bound to serve [REDACTED] profit maximization goals.

Recommendation: [REDACTED]

[REDACTED] contends that charitable purposes are being served because section [REDACTED] of the operating agreement gives [REDACTED] the unilateral right to initiate charitable activities. Section [REDACTED] authorizes [REDACTED] to undertake actions that are required to protect the tax-exempt status of [REDACTED] and the Hospital. We question, however, whether [REDACTED] authority to initiate actions are limited to only those activities which are necessary to protect its tax-exempt status. Section [REDACTED] enumerates activities that [REDACTED] may initiate, e.g., treating Medicare/Medicaid patients at the surgery center, treating indigent patients, and implementing a charity care policy. But it is unclear whether the operating agreement guarantees [REDACTED] the authority to initiate activities beyond those enumerated that may not be required to protect [REDACTED] exempt status. See Redlands Surgical Services v. Commissioner, *supra*.

Recommendation: [REDACTED]

B. Arbitration

Should a dispute over activities initiated under section [REDACTED] be taken to arbitration, the operating agreement does not direct the arbitrator to resolve issues consistent with section [REDACTED]. Section [REDACTED] of the operating agreement provides that the arbitrator shall resolve issues consistent with the purpose provision as provided in section [REDACTED] (without reference to section [REDACTED]). As stated above, section [REDACTED] permits the Joint Venture to further nonexempt purposes, does not allow [REDACTED] to initiate charitable activities, and does not state that charitable purposes will be given priority over profit maximization.

By initiating charitable activities without a clear charitable purposes statement, [REDACTED] could be liable for breaching its fiduciary duty to [REDACTED] as a member of the Joint Venture. Although section [REDACTED] may constitute an attempted waiver of the

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fiduciary duties [REDACTED] owes to [REDACTED] it is unclear whether under [REDACTED] law this waiver would be effective. [REDACTED] statement that the Joint Venture documents are enforceable does not specifically address this issue. If [REDACTED] initiate activities under this provision, it might be subject to suit by [REDACTED]

Recommendation: [REDACTED]

C. Control Over Management Decisions

In Plumstead, the Tax Court looked to the exempt partner's ability to ensure that the partnership furthered charitable purposes. In the past, we have found it sufficient in the absence of the exempt applicant's having majority control over the material decisions of a partnership that the exempt applicant have the right to initiate new charitable activities without the consent of the for-profit partner. This, coupled with an enforceable charitable purposes provision, and other binding commitments have provided the exempt applicant with the requisite level of control over the partnership's operations to ensure its activities are in furtherance of charitable purposes.

In this case, the operating agreement lacks a sufficient charitable purposes statement, contains conflicting objectives, and does not incorporate [REDACTED] right to initiate charitable activities into the purposes or arbitration provision. Furthermore, section [REDACTED] of the operating agreement provides that if [REDACTED] fails to meet an additional call for capital, its voting interest may be diluted below [REDACTED]%. A [REDACTED]% voting interest is necessary for [REDACTED] to have at least veto power, and is also necessary to trigger arbitration of disputes. New members are admitted to the Joint Venture by a majority vote. By eliminating [REDACTED] veto power, [REDACTED] control over management decisions is eliminated and it fails to meet the Plumstead requirements.

Recommendation: [REDACTED]

2. Community Benefit and Charity Care

Charitable health care organizations must benefit a broad cross-section of the community. See Sound Health Ass'n, supra. In this case, it does not appear that the Joint Venture is structured to benefit the community as a whole. As previously discussed, the operating agreement authorizes the Joint Venture to engage

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substantially in nonexempt purposes. In operation, the Joint Venture is providing very little charity care.

A. Obstacles to Poor Patients Obtaining Surgery

First, the surgery center will not have physician employees, so it is unclear how the Joint Venture will supply the needed physician services to indigent or Medicaid patients using the surgery center facility. [REDACTED] states that the physicians will bill for their services separately from the surgery center services. The file does not reflect whether the Joint Venture's charity care policy covers both physician services, or whether it only covers surgery center services. If the Joint Venture is only providing the charitable access to the facility and failing to provide charitable physician services, it is not delivering charitable health care as required under Plumstead.

Even if [REDACTED] does have the authority to compel physicians to provide charity care, the Joint Venture's projections suggest that it will actually deliver very little free care to indigents and Medicaid patients. [REDACTED] projects that it will provide [REDACTED]% free care to indigents, and [REDACTED]% Medicaid. Not only does this amount seem low in light of the per capita income of the counties in the service area (approximately \$[REDACTED]), the numbers also appear inflated. For the year [REDACTED], the projected gross patient revenues are \$[REDACTED] and the charity care and policy discounts are \$[REDACTED], which puts projected charity care in the [REDACTED]% range. See Redlands, 113 T.C. at 68. Using the gross patient revenues, projected Medicaid services are closer to [REDACTED]%.

We do not know why the projected charity care is so low, but the administrative file raises a number of questions. [REDACTED] states that it intends to operate a similar charity care policy to that of the Hospital. The Hospital's charity care policy excludes nearly two thirds of the patients from the Joint Venture's service area. The literature describing the policy requires that all applicants must be residents of [REDACTED], but the Joint Venture's service area includes [REDACTED] additional counties, [REDACTED]. Uncompensated care is provided to qualified applicants on a first-come, first-served basis, and is only available for a determined period of months. It is unclear what will happen to indigent patients who need services after the period of months has expired, or after the money runs out. There is a minimum charge of \$[REDACTED] required to qualify for charity care, and charity care extends only to inpatient services. While [REDACTED] is authorized under section [REDACTED] to implement a charity care policy, it does not appear they have implemented one yet. If the Joint Venture intends to adopt the Hospital's charity care policy, significant changes will need to be made to adapt it to the needs of the Joint Venture's service area.

B. Open Medical Staff

It is also unclear whether the Joint Venture maintains an open medical staff, or if [REDACTED] can veto the number of physicians admitted to practice at the surgery center.

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We do not know if the only physicians admitted to practice are the [REDACTED] local physician investors who own [REDACTED] or if the physicians who have privileges at the surgery center are all associated with [REDACTED]

[REDACTED] If [REDACTED] has used its veto power to restrict the number of doctors admitted to the medical staff and they in turn limit the surgery center admissions to their own patients, the Joint Venture may be operated for the private benefit of [REDACTED] and its physician investors, and not for the benefit of the community as a whole. See Rev. Rul. 69-545; Sonora Community Hospital v. Commissioner, supra.

Finally, section [REDACTED] of the operating agreement refers to the Joint Venture treating patients regardless of their ability to pay. But section [REDACTED] authorizes [REDACTED] to directly treat indigents without charge. It is unclear why the operating agreement contains two provisions that seemingly state the same thing, unless the members intend for these provisions have different meanings. [REDACTED]

Recommendation: [REDACTED]

If you wish to discuss this matter with us or have any questions, please contact me or Stephanie Caden at (202) 622-6010.



ELIZABETH PURCELL

Attachment:
Administrative File